


ANNUAL REPORT

NINETEEN HUNDRED AND SEVENTY - SEVEN



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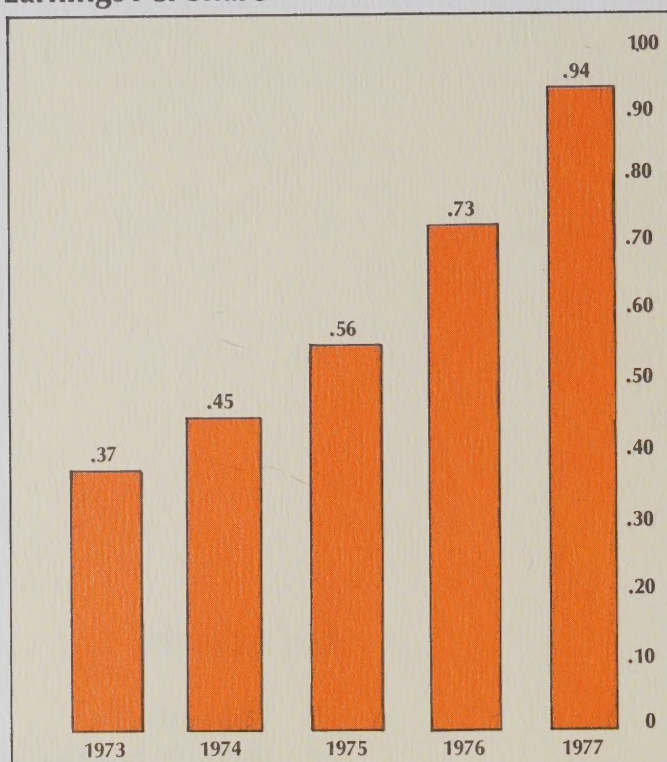
Annual Shareholders' Meeting

The Annual General Meeting of Shareholders will be held at the Winnipeg Inn, Winnipeg, Manitoba at 11:00 A.M., May 19, 1978.



INTER-CITY GAS LIMITED

Earnings Per Share



HIGHLIGHTS

FINANCIAL

	1977	1976	% Increase (Decrease)
Gross Revenues	\$ 81,994,956	\$ 67,728,285	21
Net Income	5,136,771	3,849,150	33
Per Common Share			
Net Income	.94	.73	29
Cash Dividends	.27	.24	12
Long-Term Debt	46,775,775	51,396,351	(9)
Shareholders' Equity	29,987,031	27,598,038	9
Total Assets	126,028,900	118,078,549	7
Capital Expenditures	\$ 6,644,034	\$ 7,915,195	(16)
Average Number of Common Shares Outstanding	4,296,629	4,009,253	7

OPERATING

Natural Gas Utility Sales - Mcf	26,560,185	27,951,229	(5)
Heating Units Sold	38,381	39,964	(4)
Natural Gas Production Sales - Mcf*	11,026,000	8,300,000	33
Proven Reserves at Year-End - Mcf*	129,880,000	135,600,000	(4)

*Company's Share before Deduction of Royalties



R.G. GRAHAM
President

Report to Shareholders

I am pleased to report that your company enjoyed another successful year with increased net income of 33% and earnings per common share of 94c compared with 73c in 1976. Total revenues increased by 21% to \$81,995,000 compared with \$67,728,000 in 1976. Dividends of 27c were paid on the common shares in 1977, compared with 24c last year.

Net operating profit improved in all divisions and natural gas production exceeded 7,020,000 Mcf compared with 1976 production of 5,300,000 Mcf, net after royalty.

Your company acquired a 49.8 (now 49.7)% interest in Canadian Hydrocarbons Limited on August 4, 1976 and has since announced a proposed share exchange offer to acquire all of the outstanding common shares of that company. As a registered holding company subject to the Public Utility Holding Companies Act of 1934, your company was required to obtain approvals not normally precedent to a share exchange offer. This requirement together with the conventional formalities of registration with the Securities and Exchange Commission of the United States unavoidably delayed the proposed offer. On December 23, 1977 a preliminary prospectus was filed with the Securities and Exchange Commission of the United States. When approval has been received from this governmental agency and when Canadian regulatory commissions have completed their review, the exchange offer can proceed. Approval is anticipated by mid-year.

Your company's interest in the net income of Canadian Hydrocarbons Limited was \$2,664,000 during 1977 compared with \$1,207,000 for the period August 4, to December 31, 1976. Because of the significance of this contribution to your company's net income, the similarity of operations and the planned corporate combination, the following review includes the activities of Canadian Hydrocarbons Limited. References to Canadian Hydrocarbons includes its wholly owned subsidiaries.

UTILITY OPERATIONS

Natural gas utility and transmission pipeline service is provided by wholly owned subsidiary companies of Inter-City Gas Limited to 23 communities in Manitoba, 4 in Ontario and 37 in Minnesota.

Revenue from the sale of natural gas for the year was \$52,713,000, an increase of 21% over 1976. This increase in revenue was primarily the result of the pass-through to customers of increases in the cost of purchased gas from the company's suppliers and the increased Canadian dollar equivalent of United States revenues. Operating profit of \$5,040,000 for 1977 compares with \$4,997,000 in 1976.

Although new customers were added to the utility systems, total sales volume was marginally less than 1976 due to reduced industrial demand during labour strikes and supply curtailments of large industrial boiler loads in Minnesota. The weather was also considerably warmer than normal throughout the entire service area.

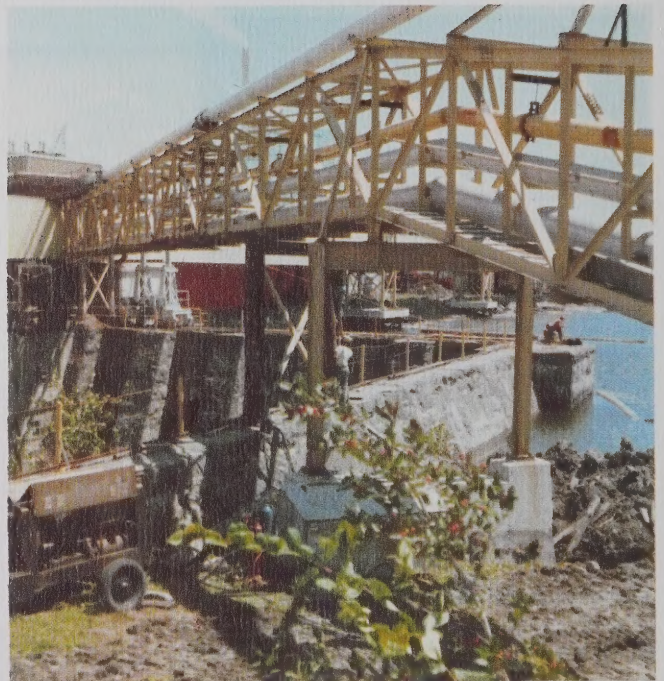
Continuing growth of the division is reflected in increased daily demand of approximately 5%. The additional volumes were acquired from the company's Canadian supplier on a long-term contract basis and will ensure days of security of service to Canadian customers on peak demand.

660 new natural gas services and 11 miles of distribution were added in 1977. New customers included a large food processing plant in Portage la Prairie, Manitoba. There are now 30,298 utility customers being served by this division.

In addition to the directly owned utility systems, through ownership of 49.7% of Canadian Hydrocarbons Limited, your company has an interest in the natural gas utility service in 94 communities and 26 farm areas in Manitoba, Alberta and in British Columbia, plus electric utility service in Yellowknife, N.W.T.

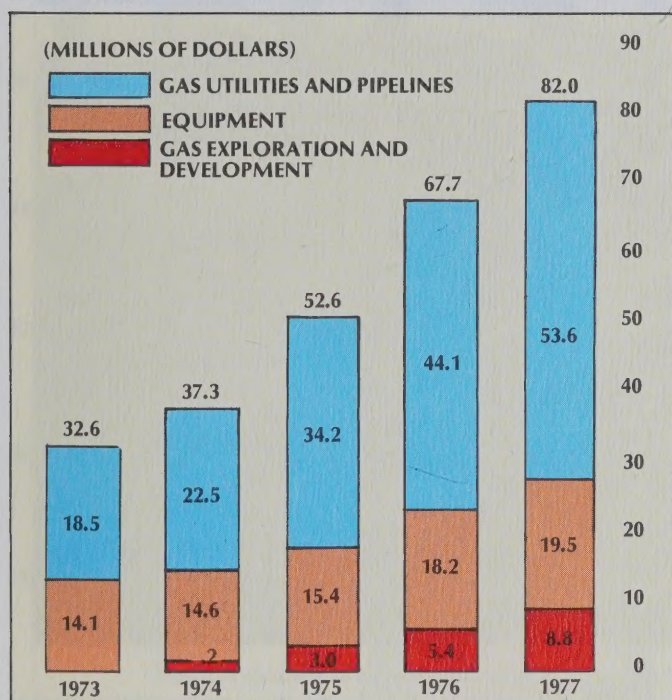
Utility revenues from the sale of gas and electricity by Canadian Hydrocarbons totalled \$28,600,000, an increase of \$6,891,000 over 1976.

Canadian Hydrocarbons subsidiaries added 2,644 gas services and 200 miles of gas transmission



Utilities service bridge to the Boise Cascade paper mill at Fort Frances, Ontario, International Falls, Minnesota.

Revenues



and distribution mains to the system during the year and there are now 45,474 gas utility customers being served.

Kilowatt hours of electricity sold in the City of Yellowknife increased by 6.3% in 1977 and contributed \$3,327,000 to revenues. Contribution to Canadian Hydrocarbons operating profits from the gas and electric utility operations was \$4,955,000 in 1977 compared to \$4,776,000 in 1976.

MANUFACTURED PRODUCTS

The company has subsidiaries which manufacture and wholesale a broad range of heating and related equipment which utilize natural gas, oil, propane and electricity. Revenue from manufacturing and wholesaling of such products increased by approximately 7% in 1977 to \$19,372,000. Contribution to operating profit was \$974,000 compared with \$840,000 in 1976.

Our sales volume accounts for approximately 14% of the oil fired furnaces, 20% of the electric furnaces and 22% of the gas fired furnaces sold in Canada during 1977.

Personnel have been added to improve sales in commercial heating; and in the domestic market a new multi-fuel furnace has received encouraging consumer acceptance.

In addition to these wholly owned equipment manufacturing and wholesaling operations, through ownership of 49.7% of Canadian Hydrocarbons Limited, your company has interests in:

- (i) the \$15,483,000 annual sales volume of equipment retailed through its Canadian subsidiaries.
- (ii) the \$15,314,000 annual volume of products sold by Thompson Pipe & Steel Company.

Thompson Pipe is a steel fabricator located in Denver, Colorado. Thompson provides engineered products for water, sewage, and hydro-electric projects. The company's manufacturing facilities includes a new spiral weld pipe mill which is capable of manufacturing steel pipe to a diameter of ten feet. During 1977 the market for new major hydro-electric and water works projects declined substantially in the company's principal service area. Loss

of sales and reduced gross margins together with increased costs attendant to the start-up of the new spiral mill produced an operating loss for 1977 of \$336,000 compared with a contribution to operating profit in 1976 of \$2,608,000.

Improvements in manufacturing methods and administrative changes have now been implemented. These include changes in senior management personnel, the consolidation of manufacturing facilities at a single location, and the restructuring of the sales organization.

PETROLEUM PRODUCTS

Canadian Hydrocarbons Limited, through subsidiaries, distributes petroleum products, primarily propane, through 211 outlets in all Canadian provinces from British Columbia to Quebec and 194 locations in five northwestern states of the United States.

Sales are made through company and dealer operated retail outlets and to wholesale distributors.

Petroleum product sales in Canada were as follows:

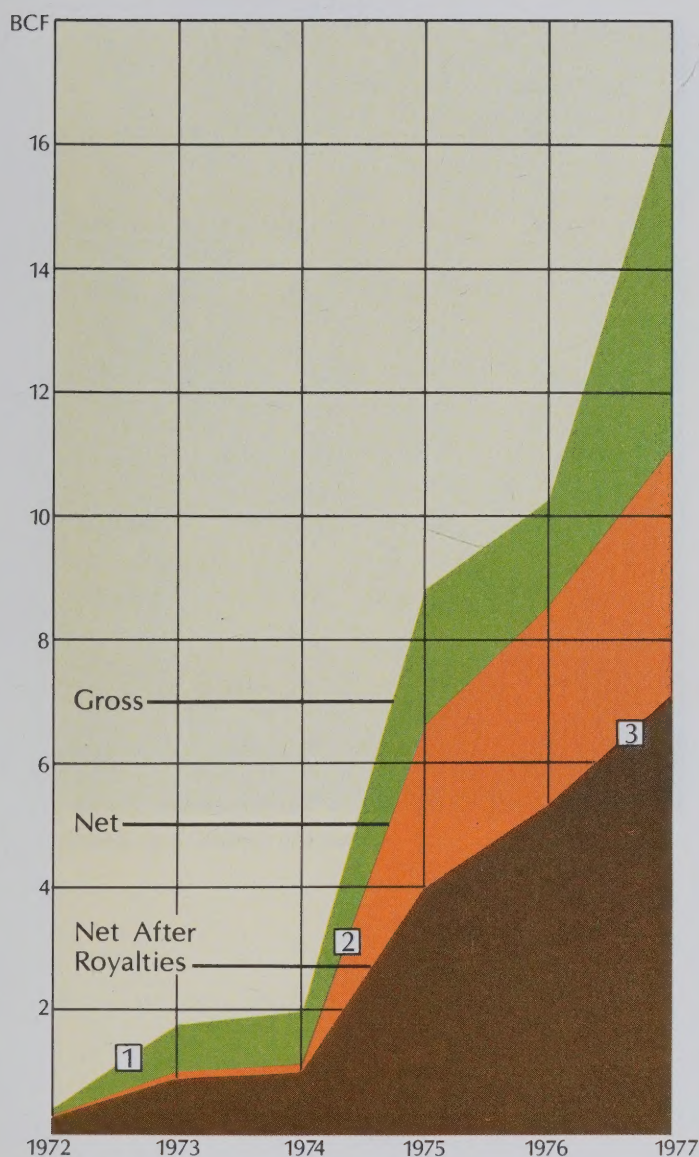
	<u>1977</u>	<u>1976</u>
Propane	\$ 76,765	\$ 68,992
Gasoline.....	39,563	43,849
Light & residual oils...	4,465	10,401
	<u>\$120,793</u>	<u>\$123,242</u>

The increase in propane revenues is due primarily to increased demand for grain drying and new industrial accounts. During 1977 the company sold unprofitable retail gasoline outlets in Ontario and Quebec and a small refinery in Saskatchewan.

The propane distribution organization in Canada underwent a major operational improvement program in 1977 and operating costs were reduced substantially. This program, together with the increase in propane revenues and the elimination of marginal operations resulted in an increased contribution to operating profits of \$2,355,000 from \$8,868,000 in 1976 to \$11,223,000 in 1977.



Gas fired furnaces in various stages of assembly process.



Inter-City Gas Limited annual gas production (billions of cubic feet).

- 1** Total gas produced from Inter-City operated properties and Inter-City net gas before royalty from non-operated properties.
- 2** Inter-City net production before royalties from all properties.
- 3** Inter-City net production after royalties from all properties.

Petroleum product sales in the United States were as follows:

	1977	1976
Propane	\$ 9,900	\$ 8,537
Gasoline	38,540	33,625
Light & residual oils . . .	22,313	21,254
	<u>\$70,753</u>	<u>\$63,416</u>

Petroleum product sales increased by 12%, however, the volume of product sold reduced due to the planned phase-out of a small crude oil refinery at Kevin, Montana. Gross profits improved through more selective marketing with contribution to operating profits increasing to \$4,261,000 in 1977 from \$3,836,000 in 1976.

The two remaining refineries in the United States are presently undergoing a major modification program in order to produce a more profitable higher octane product line. In 1977 these two refineries operated at 80% of their aggregate capacity of 10,000 barrels per day.

The natural gas processing plants in Montana and Alberta produced higher operating profits due to both increased prices and higher production levels.

EXPLORATION AND PRODUCTION

The Exploration Division of Inter-City Gas Limited participates in exploration and development drilling of gas and oil and related production activities primarily in Alberta.

Average daily production of natural gas was 30,200,000 cubic feet net before royalties in 1977 compared to 22,700,000 cubic feet in 1976. Total gas net to the company, after royalties, was 7.02 billion cubic feet, an increase from 5.3 billion cubic feet during 1976. This production generated a 58% increase in net revenue after royalties to \$8,809,000 compared to \$5,579,000 in 1976.

Contribution to operating profit was \$5,209,000 in 1977 compared to \$3,268,000 in 1976.

An independent engineering evaluation of the company's reserves is set forth in the accompanying chart.

Exploratory drilling was conducted at Medicine Hat South, Hilda, Sounding Creek, Hotchkiss, Handhills and in the Calling Lake areas of Alberta.

As a result of a three year Mobil Oil Canada Ltd.-Inter-City farm-in program at mid-year Inter-City became a working interest partner in approximately 360,000 acres of Mobil lands in the deep basin and foothills areas of Alberta.

In partnership with Mobil exploratory wells were drilled at Baseline, Fox Creek West and Amigo in the plains area, in addition to wildcats at Lovett River, Coalbranch, Robb and Mountain Park, in the foothills west of Hinton, Alberta.

In addition to these exploratory wells, development wells were drilled at Medicine Hat South, Many Islands, Tweedie and Hotchkiss for the purpose of maintaining and increasing gas production in these fields.

Additional exploratory lands were acquired in the Calling Lake and Coalbranch areas of Alberta. These acquisitions added 12,160 gross acres, bringing the gross acreage inventory to 513,500 of which 166,870 acres are net to Inter-City.

During 1977 the Exploration Division produced the following drilling results:

1977 DRILLING ACTIVITY

Wells in which Inter-City participated	49
Wells operated by Inter-City	31
Status at December 31, 1977	
Completed gas wells	39
Completed oil wells	1
Abandonments	4
Drilling	5
Total	<u>49</u>

Percentage of completed oil and gas wells 91%

Canadian Hydrocarbons participates in oil and gas exploration and production primarily through its investment in Canadian Homestead Oils Limited.

EXPLORATION DIVISION — OIL AND GAS RESERVES DECEMBER 31, 1977 (Canadian Properties)

BEFORE ROYALTY	PROVEN	PROBABLE	COMBINED
Natural Gas (thousands of cubic feet)	129,880,000	25,980,000	155,860,000
Natural Gas Liquids (thousands of barrels)	31,655	10,254	41,909
Oil (thousands of barrels)	12,600	5,040	17,640
AFTER ROYALTY	PROVEN	PROBABLE	COMBINED
Natural Gas (thousands of cubic feet)	81,315,000	13,832,000	95,147,000
Natural Gas Liquids (thousands of barrels)	23,100	7,200	30,300
Oil (thousands of barrels)	11,500	4,500	16,000



Drilling rig on location in Alberta

At December 31, 1977 Canadian Hydrocarbons Limited had expended \$14,370,000 under an Exploration Agreement with Homestead and has earned 2,441,589 of Homestead's common shares. These shares and 629,900 shares owned by Castle Oil & Gas Limited, an 85% owned subsidiary of Hydrocarbons, give Canadian Hydrocarbons an effective interest of 47% in the outstanding shares of Canadian Homestead. Under the Agreement, \$3,842,000 remains to be expended in annual installments of not less than \$1,500,000 or more than \$3,070,000. At the conclusion of the Agreement, Canadian Hydrocarbons will effectively own approximately 50% of Canadian Homestead.

Financial results for 1977 show that Homestead's gross revenue increased by 27% to a record high of \$8,404,000 and funds provided from operations increased by 25% to \$5,135,000. Net earnings of \$3,174,000 were 51% higher than the preceding year.

During 1977 Homestead participated in 58 wells of which 44 were located in Alberta, 4 were in British Columbia, 2 in Saskatchewan and 8 in the state of Texas. Drilling activity resulted in 4 oil wells and 23 gas wells. Expenditures for the year included \$6,500,000 for exploration and \$1,500,000 for development of present reserves.

Gross proven reserves at December 31, 1977, excluding the Arctic Islands, totalled 189 billion cubic feet of natural gas and 10 million barrels of crude oil and natural gas liquids. Net reserves after royalties, excluding the Arctic Islands are 130 billion cubic feet of natural gas and 7½ million barrels of crude oil and natural gas liquids.

Land holdings at year-end totalled 13.4 million gross acres equal to 5 million net acres. A significant portion of this acreage is located in the Arctic Islands and Hudson Bay regions of Canada as well as in the Province of Alberta.

Areas of current interest in which Canadian Homestead Limited is participating include the following:

Pembina — The Pembina "deep drilling" play in north-central Alberta began over a year ago with the

drilling of the discovery well which produced over 100,000 barrels of oil in the first three months of production. This discovery commenced drilling and geophysical activity which has been unsurpassed in the industry in Alberta for over a decade. Homestead's holdings in the area consist mainly of section 11-50-10-W5 which is wholly owned and the E½ of section 20-50-10-W5 in which a 25% interest is held. Extensive seismic programs have been conducted on these lands and it is expected that both parcels will be tested by drilling during 1978.

Cowpar Lake — In the Cowpar Lake region of northeastern Alberta, nine potential gas wells have now been drilled in the shallow McMurray Sands. Homestead has interests of from 50% to 100% in these wells and in 110,000 acres in the area. Other wells are planned to establish additional gas reserves.

Niteal — In the Niteal region of northeastern British Columbia, a one-third interest is held in 69,000 acres. The wells drilled to date were completed in the Mississippian zone and additional tests have been identified.

Arctic Islands — In 1976 a consortium of major oil companies committed to spend \$80 million over a period of 4 to 6 years in exploration of 33 million acres located mainly in the waters between the islands of the western Arctic. An off-shore well currently being drilled is of particular interest to Canadian Homestead since it lies in close proximity to company owned lands encompassing 280,000 gross acres. Another off-shore well is soon to be drilled on Homestead's 60% owned Melville Island permit in the Drake Point Gas Field. It will be the first Arctic sub-sea completion conducted by the consortium. Plans call for the installation of the well-head and pipeline facilities connected to an on-shore gas liquefaction plant. This project is of significance to Homestead in that, if successful, it could eventually make Homestead a beneficiary of the first gas sales from the Arctic Islands.



ON BEHALF OF
THE BOARD OF DIRECTORS

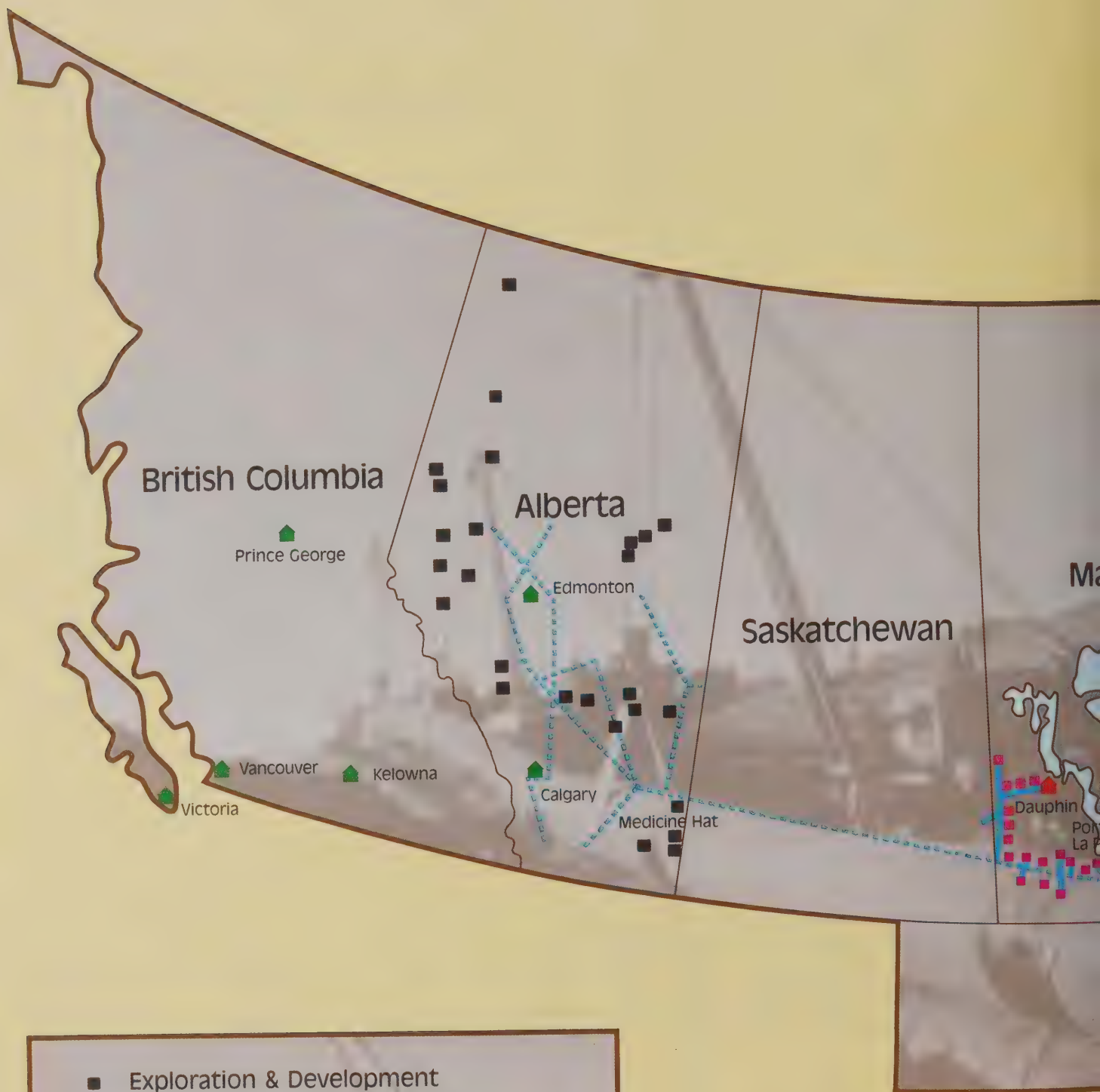


Ten Year Summary of Operations

(THOUSANDS OF DOLLARS)

	1977	1976	1975	1974
Operating Revenue				
Sale of Natural Gas				
Production Operations	\$ 8,809	5,579	2,880	177
Utility Operations	52,713	43,415	34,031	22,372
Sale of Manufactured Goods	19,372	18,129	15,266	14,292
Other Income	1,101	605	453	498
Total	81,995	67,728	52,630	37,339
Operating Expenses				
Natural Gas Purchased	43,079	34,064	24,615	14,307
Cost of Manufactured Goods Sold	15,081	14,496	11,988	10,694
Operating & Maintenance	8,635	7,194	5,781	4,468
Municipal Taxes	1,293	1,215	1,160	916
Depreciation & Depletion	3,258	2,215	1,648	919
Total	71,346	59,184	45,192	31,304
Operating Profit	10,649	8,544	7,438	6,035
Equity in Net Income of Canadian Hydrocarbons	2,664	1,207	—	—
	13,313	9,751	7,438	6,035
Financial Expenses				
Interest on Funded Debt	5,495	3,719	2,284	2,176
Other Interest and Foreign Exchange	2,086	1,225	920	839
Amortization of Financing Expenses	203	85	85	54
Interest Capitalized	(345)	(699)	(647)	(820)
Minority Interest	—	—	—	6
	7,439	4,330	2,642	2,255
Income Before Income Taxes	5,874	5,421	4,796	3,780
Income Taxes	737	1,572	2,174	1,659
Net Income for the Year	\$ 5,137	3,849	2,622	2,121
Dividends Paid				
Preferred Shares	\$ 1,100	903	713	537
Common Shares	1,160	1,031	825	683
Earnings Per Common Share	\$.94	.73	.56	.45
Fixed Assets				
Utility & Pipelines	36,278	\$35,368	35,116	33,991
Manufacturing	1,833	1,333	1,127	998
Oil & Gas Properties	28,495	23,692	16,589	13,906
Total	66,606	\$60,393	52,832	48,895
Utility Natural Gas Sales (Millions of Cubic Feet)	26,560	27,951	27,734	30,019
Utility Customers at year-end	30,298	29,781	28,699	27,376

1973	1972	1971	1970	1969	1968
—	—	—	—	—	—
18,324	17,880	15,380	10,323	8,134	7,547
14,018	9,132	6,762	2,949	2,500	—
347	183	117	131	94	159
32,689	27,195	22,259	13,403	10,728	7,706
11,467	11,491	10,234	6,685	5,104	4,903
11,118	7,488	5,708	2,541	2,013	—
3,887	3,098	2,378	1,475	1,321	848
826	756	628	509	492	453
797	668	568	410	371	330
28,095	23,501	19,516	11,620	9,301	6,534
4,594	3,694	2,743	1,783	1,427	1,172
—	—	—	—	—	—
4,594	3,694	2,743	1,783	1,427	1,172
1,725	1,023	1,174	610	435	369
607	635	341	214	295	303
59	55	28	28	23	31
(255)	(120)	(42)	(9)	(14)	(17)
3	11	22	—	30	1
2,139	1,604	1,523	843	769	687
2,455	2,090	1,220	940	658	485
1,003	547	254	264	99	11
1,452	1,543	966	676	559	474
352	362	292	221	226	230
378	248	198	158	124	119
.37	.43	.26	.18	.13	.10
32,274	30,267	28,934	25,607	17,369	15,296
935	877	555	496	471	—
6,079	4,082	624	—	—	—
39,288	35,226	30,113	26,103	17,840	15,296
27,579	29,680	25,904	16,387	12,869	13,299
25,451	23,986	22,644	20,629	19,941	18,126



- Exploration & Development
- ▲ Branch Offices (Gas Distribution)
- Gas Distribution Systems
- ▲ Branch Offices (Equipment Distribution)
- Manufacturing Plants
- Inter-City Gas Transmission Systems
- - - Other Major Gas Pipelines

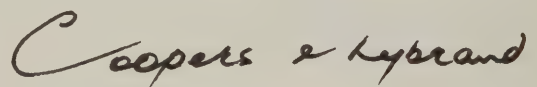


Auditors' Report to the Shareholders

We have examined the consolidated balance sheet of Inter-City Gas Limited as at December 31, 1977 and the consolidated statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1977 and the results of its operations and the changes in its financial position for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Winnipeg, Manitoba
April 12, 1978

A handwritten signature in cursive script that reads "Coopers & Lybrand".

CHARTERED ACCOUNTANTS

Consolidated Statement of Income



for the years ended December 31, 1977 and 1976

	1977 \$	1976 \$
Operating Revenue		
Sale of natural gas -		
Utility operations	52,713,118	43,415,006
Production operations	8,808,879	5,579,046
Sale of manufactured goods	19,372,120	18,129,171
Other revenue	1,100,839	605,062
	<u>81,994,956</u>	<u>67,728,285</u>
Operating Expenses		
Natural gas purchased	43,079,540	34,063,721
Cost of manufactured goods sold	15,080,680	14,496,040
Operating and maintenance	8,634,679	7,194,502
Municipal taxes	1,292,912	1,215,013
Depreciation and depletion	3,258,138	2,215,279
	<u>71,345,949</u>	<u>59,184,555</u>
	10,649,007	8,543,730
Equity in Net Income of Canadian Hydrocarbons Limited (note 2)	<u>2,663,946</u>	<u>1,207,300</u>
	<u>13,312,953</u>	<u>9,751,030</u>
Financial Expenses		
Interest on long-term debt	5,494,607	3,719,166
Other interest	1,274,311	1,274,678
Amortization of financing expenses and goodwill	203,314	85,230
Interest capitalized	(344,888)	(699,006)
Loss (gain) on foreign exchange	812,143	(50,363)
	<u>7,439,487</u>	<u>4,329,705</u>
Income Before Income Taxes	5,873,466	5,421,325
Provision for Income Taxes (note 8)	736,695	1,572,175
Net Income for the Year	<u>5,136,771</u>	<u>3,849,150</u>
Net Income per common share (note 10)	<u>94 cents</u>	<u>73 cents</u>

Inter-City Gas Limited

Consolidated Balance Sheet

as at December 31, 1977 and 1976

	1977 \$	1976 \$
ASSETS		
Current Assets		
Cash	1,528,239	1,828,766
Accounts receivable (note 3) -		
Trade and sundry	17,177,775	15,874,555
Conditional sales contracts	69,047	75,716
Affiliated companies	377,301	—
Income taxes recoverable	277,109	185,375
Inventories (notes 3 and 4)	7,214,115	6,416,751
Prepaid expenses and deposits	302,700	317,480
	<u>26,946,286</u>	<u>24,698,643</u>
Investments		
Shares of Canadian Hydrocarbons Limited (note 2)	40,626,561	38,783,108
Advances to the trustees of employee share		
purchase plans (note 5)	783,286	862,798
Other - at cost	19,200	24,699
	<u>41,429,047</u>	<u>39,670,605</u>
Fixed Assets (note 6)		
Property, plant and equipment - at cost	66,606,174	60,393,085
Accumulated depreciation and depletion	11,627,399	8,875,210
	<u>54,978,775</u>	<u>51,517,875</u>
Other Assets and Deferred Charges -		
at cost, less amortization		
Financing expenses	872,046	944,702
Natural gas market development	232,119	285,784
Rate hearings and other	1,181,018	758,890
Goodwill	389,609	202,050
	<u>2,674,792</u>	<u>2,191,426</u>
Signed on behalf of the Board		
		
Director	<u>126,028,900</u>	<u>118,078,549</u>
		
Director		

LIABILITIES	1977 \$	1976 \$
Current Liabilities		
Bank advances (note 3)	18,456,297	16,546,749
Accounts payable and accrued liabilities	13,155,350	10,369,536
Income taxes payable	124,070	289,347
Current portion of long-term debt	11,818,897	7,086,535
Customers' security deposits	195,550	187,410
	<u>43,750,164</u>	<u>34,479,577</u>
Customers' Contributions in Aid of Construction	423,983	396,950
Long-Term Debt (note 7)	46,775,775	51,396,351
Deferred Income Taxes (note 8)	5,091,947	4,207,633
	<u>96,041,869</u>	<u>90,480,511</u>
 SHAREHOLDERS' EQUITY		
Stated Capital (note 9)		
Authorized		
600,000 first preference shares issuable in series		
262,468 second preference shares issuable in series		
10,000,000 common shares		
Issued and fully paid -		
246,450 Series B first preference shares (1976 - 265,000)	4,929,000	5,300,000
200,000 Series C first preference shares (1976 - 200,000)	4,000,000	4,000,000
94,268 Series A second preference shares (1976 - 97,268)	1,885,360	1,945,360
87,085 Series B second preference shares (1976 - 90,200)	1,741,700	1,804,000
4,297,495 common shares (1976 - 4,295,795)	6,947,331	6,941,381
	<u>19,503,391</u>	<u>19,990,741</u>
Retained Earnings	10,483,640	7,607,297
	<u>29,987,031</u>	<u>27,598,038</u>
	<u>126,028,900</u>	<u>118,078,549</u>

Consolidated Statement of Changes in Financial Position

for the years ended December 31, 1977 and 1976

	1977 \$	1976 \$
Source of Funds		
Provided from operations	7,448,847	7,170,742
Proceeds from first preference shares Series C	—	4,000,000
Proceeds from issue of common shares	5,950	3,008,465
Term bank loans	—	35,763,172
Customers' contributions in aid of construction	27,033	42,314
Proceeds from sale of fixed assets	136,534	—
Decrease in investments	85,011	—
Proceeds from redemption of preferred shares of Canadian Hydrocarbons Limited	97,500	97,500
	<u>7,800,875</u>	<u>50,082,193</u>
Use of Funds		
Additions to utility systems and other equipment	1,758,036	748,415
Additions to petroleum and natural gas properties, exploration costs and well equipment	4,885,998	7,166,780
Redemption of long-term debt	4,795,576	12,970,184
Dividends paid to shareholders	2,260,428	1,933,894
Redemption of preference shares	493,300	110,000
Cost of shares in Canadian Hydrocarbons Limited	—	32,287,381
Other assets and deferred charges	630,481	568,716
Increase in other investments	—	104,114
	<u>14,823,819</u>	<u>55,889,484</u>
Increase in Working Capital Deficiency	7,022,944	5,807,291
Working Capital Deficiency - Beginning of Year	<u>9,780,934</u>	<u>3,973,643</u>
Working Capital Deficiency - End of Year	<u>16,803,878</u>	<u>9,780,934</u>
Working capital deficiency is represented by:		
Current liabilities	43,750,164	34,479,577
Current assets	<u>26,946,286</u>	<u>24,698,643</u>
	<u>16,803,878</u>	<u>9,780,934</u>

Inter-City Gas Limited

Consolidated Statement of Retained Earnings

for the years ended December 31, 1977 and 1976

	1977 \$	1976 \$
Balance - Beginning of Year	7,607,297	5,692,041
Net income for the year	<u>5,136,771</u>	<u>3,849,150</u>
	<u>12,744,068</u>	<u>9,541,191</u>
Dividends paid -		
First preference shares Series B	421,946	437,250
First preference shares Series C	420,000	202,807
Second preference shares Series A	126,253	127,163
Second preference shares Series B	132,064	135,750
Common shares	<u>1,160,165</u>	<u>1,030,924</u>
	<u>2,260,428</u>	<u>1,933,894</u>
Balance - End of Year	<u><u>10,483,640</u></u>	<u><u>7,607,297</u></u>

Notes To Consolidated Financial Statements

for the years ended December 31, 1977 and 1976

1. SIGNIFICANT ACCOUNTING POLICIES

Consolidation —

The consolidated financial statements include the assets, liabilities and operating results of all subsidiary companies. The accounts of subsidiary companies are consolidated from the dates of acquisition on the basis of purchase accounting. The amounts by which the purchase price of the subsidiary companies exceeds the fair market value of the assets acquired have been treated as goodwill and are being amortized on a straight line basis over ten and twenty years.

Foreign exchange —

The accounts of subsidiaries and divisions operating in the United States are translated into Canadian dollars at the rates of exchange on the balance sheet date for current assets and current liabilities, on the date of the transaction for other balance sheet accounts and at the average rate for the year for revenues and expenses. Gains and losses on translation are charged to income in the year realized.

Fixed assets —

Natural gas transmission and distribution systems and buildings and equipment are stated at cost which includes interest and overhead amounts capitalized during the construction period. Depreciation is provided on the straight line method with rates varying between 1.7% and 33.0% based on the estimated useful life of those assets.

Petroleum and natural gas properties, exploration costs and well and gathering systems are accounted for on the full cost method of accounting, whereby all costs, including interest and overhead, of exploring for and developing petroleum and natural gas properties are capitalized. These costs are depleted by the unit of production method based on estimated recoverable reserves.

Inventories —

Inventories are stated at the lower of cost or net realizable value. Cost is determined for work in process and finished goods at standard prices and for raw materials and supplies on a first-in, first-out basis.

Deferred charges —

Amortization of financing expenses and other deferred charges is provided on the straight line method over periods of five to twenty years.

Income taxes —

Regulatory agencies have directed certain subsidiary companies to provide only those income taxes currently payable in their financial statements and in calculating their rates of return for rate making purposes. However, for all other operations, the company, in accordance with the recommendations of the Canadian Institute of Chartered Accountants, provides for deferred income taxes on all timing differences between accounting income and taxable income, including those relating to its exploration, development and acquisition of petroleum and natural gas properties.

2. INVESTMENT IN CANADIAN HYDROCARBONS LIMITED

In 1976, the company acquired 2,556,656 common shares of Canadian Hydrocarbons Limited and preference shares with a par value of \$5,915,000. At December 31, 1977, the company's equity interest in Canadian Hydrocarbons Limited amounted to 49.7%.

The company is following the equity method of accounting for its interests in Canadian Hydrocarbons Limited and the investment is composed of:

	1977	1976
	\$	\$
Common stock at equity	34,906,561	32,965,608
Preferred shares at cost	<u>5,720,000</u>	<u>5,817,500</u>
	<u>40,626,561</u>	<u>38,783,108</u>

The company's equity in the net income of Canadian Hydrocarbons Limited of \$2,663,946 is stated after deducting the company's share of extraordinary items as follows:

	\$	Per share amount
Loss on disposal of discontinued business	469,300	0.11
Reduction of income taxes on application of prior years' losses	281,600	0.07
	<u>187,700</u>	<u>0.04</u>

In May 1977, the company announced a proposed exchange offer to the shareholders of Canadian Hydrocarbons Limited whereby it would exchange one and one-half shares of Inter-City Gas Limited for each common share in Canadian Hydrocarbons Limited. This exchange offer is subject to the approval of the Securities and Exchange Commission, Washington and the Securities Commission in Canada.

On December 30, 1977, Canadian Hydrocarbons Limited purchased 1,037,250 common shares of the company from a third party at \$10.00 per share. In January 1978, the company granted an option to Canadian Hydrocarbons Limited to acquire up to 2,300,000 common shares at a price of \$11.00 per share. The option is exercisable at any time during the period ending December 29, 1978.

If the option is exercised, Canadian Hydrocarbons Limited will increase its shareholdings in the company to approximately 51% (diluted to 46% after the exercise of all the company's outstanding warrants). In the event that the company acquires more than 50% of the common shares of Canadian Hydrocarbons Limited the option will not be exercisable.

3. SECURITY FOR BANK ADVANCES AND TERM LOANS

Current and term bank loans are generally secured by a pledge of inventories, accounts receivable, production proceeds, shares of certain companies and interests in certain petroleum and natural gas properties. In addition, a demand debenture in the amount of \$3,500,000 securing a floating charge on the non-utility assets has been given as collateral security.

4. INVENTORIES

Inventories are classified as follows:

	1977 \$	1976 \$
Raw materials	1,430,785	1,161,794
Work in process	564,158	486,193
Finished goods	4,524,012	3,995,366
Materials and supplies	695,160	773,398
	<u>7,214,115</u>	<u>6,416,751</u>

5. EMPLOYEE SHARE PURCHASE PLANS

No common shares were purchased by the trustees of the plans during 1977 (43,838 shares were purchased in 1976). An amount of \$79,512 was repaid during the year by the trustees to the company and the balance due from the trustees at December 31, 1977 amounted to \$783,286 (1976 - \$862,798).

6. FIXED ASSETS

Property, plant and equipment are classified as follows:

	Cost \$	Accumulated depreciation and depletion \$	1977 \$	1976 \$
Utility transmission and distribution systems	35,796,394	6,214,363	29,582,031	29,457,355
Petroleum and natural gas properties and exploration costs	18,838,343	2,689,625	16,148,718	13,522,064
Well equipment and gathering systems	9,656,595	1,862,151	7,794,444	7,510,473
Land and buildings	737,173	223,548	513,625	484,830
Machinery, equipment and furniture	1,577,669	637,712	939,957	543,153
	<u>66,606,174</u>	<u>11,627,399</u>	<u>54,978,775</u>	<u>51,517,875</u>

7. LONG-TERM DEBT

The details of long-term debt of the company are as follows:

	1977		1976	
	Current \$	Long-Term \$	Current \$	Long-Term \$
Inter-City Gas Limited -				
Term bank loans bearing interest at 1% to 3% above bank prime rate due 1980 and 1981 (Canadian \$600,000 - U.S. \$4,900,000)	931,744	4,553,615	766,840	4,455,475
7% debentures - Series B maturing 1982	79,500	730,000	79,500	825,000
8% first mortgage bonds - Series A maturing 1989 (U.S. \$3,250,000)	164,160	3,341,335	151,350	3,503,012
9½% first mortgage bonds - Series B maturing 1994 (U.S. \$1,700,000)	109,440	1,548,160	100,900	1,644,920
9½% first mortgage bonds - Series C maturing 1994	50,000	800,000	50,000	850,000
Inter-City Gas Utilities Ltd. -				
6% first mortgage bonds - Series A maturing 1977	—	—	37,500	—
6% first mortgage bonds - Series B maturing 1982	25,000	200,000	25,000	225,000
6% first mortgage bonds - Series C maturing 1985	92,000	1,438,000	57,000	1,530,000
7% debentures - Series A maturing 1979	30,000	255,000	25,500	287,500
Inter-City Pipelines Ltd. -				
Term bank loans bearing interest at 1% to 1½% above bank prime rate, due 1981 and 1984	385,000	4,720,000	770,000	4,720,000
Inter-City Minnesota Pipelines Ltd. and ICG Transmission Limited				
9½% joint and several promissory note due 1991, secured by 8% joint and several first mortgage bonds maturing 1991 (U.S. \$3,705,000)	290,016	3,486,383	267,385	3,754,956
Minell Pipeline Ltd. -				
Term bank loan bearing interest at 3% above bank prime rate, due 1980 (U.S. \$501,667)	76,608	431,667	70,630	501,666
Inter-City Manufacturing Ltd. -				
Term bank loans bearing interest at 1% to 1¼% above bank prime rate, due 1980 and 1983	1,620,000	23,530,000	1,890,000	22,780,000
Term bank loans bearing interest at 0.37% to 1¼% above bank prime rate, due 1978 and 1980 (U.S. \$8,912,500)	7,940,429	1,642,500	2,794,930	6,318,822
Non-interest bearing note payable, due 1982	25,000	99,115	—	—
	<u>11,818,897</u>	<u>46,775,775</u>	<u>7,086,535</u>	<u>51,396,351</u>

Long-term debt amounts repayable in United States funds are translated into Canadian funds at the exchange rates in effect at their respective dates of issue except for current maturities which are translated at the year-end rate. If long-term debt payable in United States funds was translated at the exchange rate in effect at year-end, it would result in an increase in long-term debt of \$1,216,000 at December 31, 1977 (\$191,000 at December 31, 1976).

Under the provisions of the various indentures and agreements the company is required to make the following sinking fund instalments and term bank loan repayments during the next five years:

Year	\$
1978	11,818,897
1979	5,847,518
1980	9,104,126
1981	9,023,298
1982	5,791,391

8. INCOME TAXES

A reconciliation between statutory and the effective rate of income taxes is provided as follows:

	1977 \$	1976 \$
Combined federal and provincial income taxes at 46% on income less equity income in Canadian Hydrocarbons Limited	1,476,379	1,938,451
Increase (decrease) in income taxes resulting from -		
Regulated natural gas divisions	(105,700)	(76,800)
Alberta royalty credits	(1,000,000)	(604,120)
Provincial and foreign taxes in excess of federal abatement	366,016	314,644
Effective income taxes	<u>736,695</u>	<u>1,572,175</u>

Included in the provision for income taxes are the amounts of deferred income taxes resulting from timing differences between accounting income and taxable income. These amounts are \$884,314 in 1977 and \$1,271,925 in 1976.

If tax allocation had been followed in respect of all timing differences between accounting income and taxable income, the provision for deferred income taxes would have increased and consolidated net income would have decreased by \$105,700 (1976 - \$76,800). At December 31, 1977, the accumulated deferred income taxes would have amounted to approximately \$4,412,000 (1976 - \$4,306,300), in addition to the amounts recorded in the accounts.

9. STATED CAPITAL

(a) Authorized —

The first preference shares have been designated as 265,000 Series B shares carrying a cumulative dividend entitlement of \$1.65 per share and currently redeemable at \$22.00 and 200,000 Series C shares carrying a cumulative dividend entitlement of \$2.10 per share and redeemable at \$22.00 but not before July 1978.

The second preference shares have been designated as 97,268 Series A shares carrying a cumulative dividend entitlement of \$1.30 per share and redeemable at a price not to exceed \$20.63 and 90,200 Series B shares carrying a cumulative dividend entitlement of \$1.50 per share and redeemable at a price not to exceed \$21.35.

(b) Purchase funds —

The preference shares have various purchase fund requirements as follows:

First preference shares Series B —

To purchase annually, 7% of the original issue amount for each of the five years commencing in 1977, 13% for each of the next five years and 5% for each year thereafter. In 1977, 18,550 shares were purchased and cancelled.

First preference shares Series C —

To offer to purchase annually, 7% of the original issue amount for each of the five years commencing in 1977, 13% for each of the next five years and 5% for each year thereafter. No shares were cancelled in 1977.

Second preference shares Series A and B —

To purchase annually, in the market a minimum of 3% of the original issue amount outstanding at the end of the preceding year. In 1977, 3,000 Series A and 3,115 Series B shares were purchased and cancelled (1976 - 2,400 and 3,100).

The minimum purchase requirements in the next five years are as follows:

Year	\$
1978	829,838
1979	826,029
1980	822,368
1981	818,814
1982	1,396,663

(c) Warrants and options —

The company has reserved 597,640 common shares on the exercise of share purchase warrants at \$3.50 per share up to July 31, 1981. During the year, 1,700 warrants were exercised for a consideration of \$5,950 (1976 - 560 warrants - \$1,730).

In January 1978, the company granted an option to Canadian Hydrocarbons Limited on 2,300,000 common shares at \$11.00 per share exercisable during the period ending December 29, 1978.

10. NET INCOME PER COMMON SHARE

The net income per common share is calculated on the weighted average number of shares outstanding during the respective years. For the purpose of calculating the dilution, if any, per common share it has been assumed that the share warrants for 597,640 common shares were exercised on January 1, 1977 and the proceeds received therefrom earned a rate of return equivalent to that earned on the book value of the common shareholders' equity in 1977. Based on this assumption, there is no dilution of the 1977 net income per common share. The amount of imputed income was \$528,044 after income taxes.

11. PENSION PLANS

The company has various pension plans available to certain groups of permanent full-time employees. The company makes contributions to the plans based on salary levels and the cost to the company was \$173,156 for the year ended December 31, 1977 (1976 - \$146,288). Unfunded liabilities for past service benefits at December 31, 1977 amounted to approximately \$46,000 (Canadian) for the Canadian plans and \$237,000 (U.S.) for the United States plan.

12. SUPPLEMENTARY INFORMATION

	1977 \$	1976 \$
(a) Included in other revenue are the following amounts -		
Income from investments	357,124	186,237
Discount on shares and debentures purchased for cancellation	14,037	34,709
(b) Included in operating and maintenance expenses are the following amounts for the amortization of deferred charges -		
Natural gas market development	57,409	52,603
Rate hearings and other	113,604	61,898
(c) The aggregate remuneration paid to directors and senior officers of the company in their capacity as director, officer or employee	354,650	426,950

13. ANTI-INFLATION ACT

The company is subject to the restraint of dividends under the terms of the Anti-Inflation Act and Regulations which became effective October 14, 1975.

The amount of dividends which the company can declare or pay during the period from October 14, 1977 to October 13, 1978 will be limited to 28 cents per common share. Of this amount, 14 cents per common share was paid to shareholders in two dividends of 7 cents per common share paid November 15, 1977 and December 30, 1977.

14. COMMITMENT

The company has an agreement with one of its bankers who holds 205,000 shares of Canadian Hydrocarbons Limited whereby the bank may, up to December 31, 1983, require the company to purchase those shares at a price equal to the greater of \$13.00 or the last trade on the Toronto Stock Exchange on the day before the notice to purchase is given.



INTER-CITY GAS LIMITED

DIRECTORS

C. ROY BEENHAM
Winnipeg, Manitoba
Senior Vice-President
Inter-City Gas Limited

G. R. CHATER
Toronto, Ontario
President, Grafton Group Limited

H. E. DYNES
Toronto, Ontario
President and Chief Executive Officer
Traders Group Limited

ROBERT G. GRAHAM
Winnipeg, Manitoba
President and Chief Executive Officer
Inter-City Gas Limited

WAYNE R. HARDING
Winnipeg, Manitoba
Executive Vice-President
Inter-City Gas Limited

JAMES W. McCUTCHEON, Q.C.
Toronto, Ontario
Partner
Shibley, Righton & McCutcheon

GORDON P. OSLER
Toronto, Ontario
Vice-Chairman of the Board
British Steel Corporation (Canada) Ltd.
and Chairman of the Board
Slater Steel Industries Ltd.

E. P. RIMMER P. Eng.
Winnipeg, Manitoba
Vice-President
Inter-City Gas Limited

ALAN SWEATMAN, Q.C.
Winnipeg, Manitoba
Partner
Thompson, Dorfman, Sweatman

OFFICERS

ROBERT G. GRAHAM
President and Chief Executive Officer

WAYNE R. HARDING, C.A.
Executive Vice-President

C. ROY BEENHAM
Senior Vice-President

E. P. RIMMER, P. Eng.
Vice-President

R. J. DAHNKE, P. Eng.
Vice-President

BARRÉ W. HALL, LL.M.
Secretary

ROBERT W. DUNBAR, C.A.
Controller

SOLICITORS

THOMPSON, DORFMAN, SWEATMAN

AUDITORS

COOPERS & LYBRAND

TRANSFER AGENTS AND REGISTRAR

GUARANTY TRUST COMPANY
430 Portage Avenue
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R3C 0C9

Offices in Winnipeg, Toronto,
Calgary and Vancouver

HEAD OFFICE

Inter-City Gas Building
444 St. Mary Avenue
Winnipeg, Manitoba
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TO THE SHAREHOLDERS

For the six months ended June 30, 1977, Inter-City's earnings totalled \$2,808,000, or 53¢ per share which is a 43% increase in earnings per share over the corresponding period in 1976. The improvement in earnings is mainly attributed to higher levels of natural gas production with related operating profits from the company's exploration division this year. The investment in Canadian Hydrocarbons has resulted in a net contribution to earnings of 5¢ per share for the current year.

Operating revenues to date total \$40,180,000, up from \$31,346,000 last year. This revenue gain is due principally to higher prices for natural gas, even though the continued unseasonably mild weather has caused a slight decline in the volume of gas sold by the utility and pipeline division.

On May 17, 1977, Inter-City Gas Limited announced the making of a share exchange offer for all the outstanding shares of Canadian Hydrocarbons Limited. The basis of the offer will be one and one-half common shares of Inter-City for each share of Canadian Hydrocarbons and will be conditional upon not less than 60% of the shares of Canadian Hydrocarbons not now owned by Inter-City Gas being tendered for exchange.

Inter-City now owns 49.8% of the total outstanding common shares of Canadian Hydrocarbons.

The offer will be made only by means of prospectus after the necessary securities registration requirements are met in Canada and the United States. Inter-City Gas Limited expects that these registration and other requirements can be met by year end.

August 19, 1977

R.G. Graham
President.

TRANSMISSION AND
DISTRIBUTION OF NATURAL GAS

MANUFACTURING AND
DISTRIBUTION OF HEATING EQUIPMENT

EXPLORATION AND DEVELOPMENT
OF OIL AND GAS RESOURCES



Inter-City Gas
L I M I T E D

**Inter-City
Gas**



INTER-CITY GAS LIMITED

Consolidated Statement of Income (Unaudited)
For the Six Months Ended June 30, 1977 and 1976

OPERATING REVENUE		1977	1976
Sale of Natural Gas			
Utility Operations	\$28,029,612	\$21,237,032	
Exploration Operations	4,025,913	2,588,222	
Sale of Manufactured Goods	7,651,649	7,301,952	
Other Revenue	472,750	208,623	
	<u>40,179,924</u>	<u>31,345,829</u>	
OPERATING EXPENSES			
Natural Gas Purchased	22,650,820	16,192,923	
Cost of Manufactured Goods			
Sold	5,920,810	5,732,466	
Operating & Maintenance	4,181,394	3,459,671	
Municipal Taxes	686,588	608,352	
Depreciation & Depletion	<u>1,280,679</u>	<u>976,087</u>	
	34,720,291	26,969,499	
OPERATING PROFIT	<u>5,459,633</u>	<u>4,376,330</u>	
FINANCIAL EXPENSES			
Interest on Long-Term Debt	2,677,140	1,136,612	
Other Interest	739,678	625,551	
Amortization of Financing Expenses and Goodwill	70,493	36,874	
Interest Capitalized	<u>(193,536)</u>	<u>(366,696)</u>	
	3,293,775	1,432,341	
INCOME BEFORE INCOME TAXES	2,165,858	2,943,989	
INCOME TAXES	<u>731,100</u>	<u>1,231,000</u>	
INCOME BEFORE EQUITY IN NET INCOME OF CANADIAN HYDROCARBONS LIMITED	1,434,758	1,712,989	
EQUITY IN NET INCOME OF CANADIAN HYDROCARBONS LIMITED	<u>1,373,590</u>	<u>—</u>	
NET INCOME FOR THE PERIOD	<u>\$ 2,808,348</u>	<u>\$ 1,712,989</u>	
NET INCOME PER COMMON SHARE	<u>\$.53</u>	<u>\$.37</u>	
AVERAGE COMMON SHARES OUTSTANDING	4,295,812	3,722,524	

INTER-CITY GAS LIMITED

Consolidated Statement of Changes in Financial Position (Unaudited)
For the Six Months Ended June 30, 1977 and 1976

	1977	1976
SOURCE OF FUNDS		
Provided from Operations	\$ 3,351,024	\$ 3,376,848
Proceeds from Issue of Common Shares	2,450	3,006,735
Decrease in Investments	65,174	-
Term Bank Loans	<u>2,455,420</u>	<u>-</u>
	5,874,068	6,383,583
USE OF FUNDS		
Additions to Utility Systems & Other Equipment	280,670	269,520
Additions to Petroleum and Natural Gas Properties, Exploration Costs and Well Equipment	1,611,674	2,515,056
Repayment of Long-Term Debt	1,692,205	1,626,201
Redemption of Preference Shares	395,000	104,000
Dividends Paid to Shareholders	711,346	867,566
Financing Expenses and Other Deferred Charges	203,303	281,933
Purchase of Shares of Subsidiary Companies	4,171	-
Refund of Customers' Contributions in Aid of Construction	39,380	12,838
Increase in Investments	-	119,860
	<u>4,937,749</u>	<u>5,796,974</u>
INCREASE IN WORKING CAPITAL	<u>\$ 936,319</u>	<u>\$ 586,609</u>